

# RESERVE BANK PREVIEW

## Europe tips RBA Over the Line

Monday, 5 December, 2011

- European developments remain top of mind for the RBA. The increasing concern of policy makers around the globe is reflected in recent co-ordinated action by six central banks last week, highlighting the depth of the crisis in Europe.
- We believe that the risks to the European debt crisis remain great. These risks, along with recent data revealing that the soft patches in the domestic economy are yet to make a marked recovery, suggest to us that the odds now favour a 25bp rate cut tomorrow. However, tomorrow's RBA decision is still likely to be a close call.
- We still believe the RBA will cut again in February next year. Any further cuts beyond this will rely heavily on European developments. The deeper the crisis and the longer it takes to arrive at an effective solution, the greater the downside risks to the global economic and financial system and the more likely the RBA might need to tap on the accelerator further.

The Reserve Bank (RBA) meets tomorrow to discuss interest-rate settings.

The RBA last cut rates on November 1 by 25bp to 4.50%. In their accompanying statement on this date, the two overwhelming factors that dictated their decision to cut policy were the downside risks from the European sovereign debt crisis and the soft patches in the domestic economy. The lower inflation outlook also gave the RBA room to cut rates.

The RBA also indicated it wanted to take interest rates to a more neutral setting, where neutral is that level of rates that doesn't apply nor withdraw stimulus to the economy. On this aim alone, we expect the RBA will cut rates at least one more time within the next few months. However, with the persistent and deepening European sovereign debt crisis, the risk remains that the RBA might need to cut by more.

Last week, six central banks, led by the US Federal Reserve, took co-ordinated action to lower swap rates and the cost of borrowing. The central banks involved agreed to lower the pricing on the existing temporary US dollar liquidity swap arrangements by 50bp so that the new rate will be the US dollar Overnight Index Swap (OIS) rate plus 50bp. The purpose of these actions is to ease strains in financial markets and thereby mitigate the effects of such strains on the supply of credit to households and businesses and so help foster economic activity. It is not a solution to the European debt crisis, but it does improve liquidity pressures.

This co-ordinated action in itself highlights the depth of the crisis in Europe and how increasingly concerned policymakers across the globe are about it. There as yet does not appear to be any swift and effective single solution to the crisis.

Latest developments to containing the crisis involve Europe turning to the International Monetary Fund (IMF). European policy makers are looking to the fund to help ensure budgetary restraint while also serving as a vehicle for financing. It might help but the risk is that it will not wave the problems away. The IMF currently lacks the resources to create the much-discussed "firewall" to keep interest rates at sustainable levels for the troubled bigger euro zone economies. Italy and Spain together have total debts of more than US\$3.3 trillion, with Italy about to roll over US\$276 billion in debt over in the next six months and Spain about US\$150 billion. Just those two rollovers would wipe out the amount the fund has available to lend worldwide, about US\$400 billion.

One option that is gaining support is a plan to have Euro zone central banks lend money to the IMF. The fund could then provide lines of credit to countries struggling to finance their debts, and could participate in fiscal monitoring.

On balance, we believe that the risks to the European debt crisis remain great. Together with

recent data that revealed the soft patches in the domestic economy are yet to make a marked recovery suggests to us that the odds have shortened for a 25bp rate cut tomorrow.

We still also believe the RBA will cut again in February next year (after the release of inflation data for Q4). So we see the cash rate falling to 4% next year. Any further cuts beyond this 4% level will rely heavily on European developments. The deeper the crisis and the longer it takes to arrive at an effective solution, the greater the downside risks to the global economic and financial system and the more likely the RBA might need to tap on the accelerator further.

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